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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MIKE GLEASON
KRISTIN K. MAYES
BARRY WONG

IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR A HEARING TO DETERMINE THE FAIR VALUE OF THE UTILITY PROPERTY OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN, AND TO AMEND DECISION NO. 67744.	DOCKET NO. E-01345A-05-0816 **NOTICE OF FILING TESTIMONY**

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Notice is given that the Arizona Utility Investors Association has filed the Direct Testimony of Julie M. Cannell on its behalf in the above-entitled docket. An Executive Summary of the Testimony is included at page ES-1 of the Direct Testimony.

RESPECTFULLY SUBMITTED this 18th day of August, 2006.

GALLAGHER & KENNEDY, P.A.

By Michael M. Grant

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Arizona Corporation Commission
DOCKETED

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DIRECT TESTIMONY OF JULIE M. CANNELL

On Behalf of the Arizona Utility Investors Association

Docket No. E-01345A-05-0816

August 18, 2006

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EXHIBITS

EXHIBIT JMC-1	**PROFESSIONAL QUALIFICATIONS**

EXECUTIVE SUMMARY

OF

JULIE M. CANNELL

Based upon my 20 years of experience as a securities analyst and portfolio manager as well as my review of rating agencies' and equity analysts' perceptions of Arizona Public Service ("APS") and its parent company, Pinnacle West Capital, I conclude the 11.5% return on equity requested by APS is reasonable and comports with investors' expectations. Additionally, investors support changes to the Power Supply Adjustor which will assure more timely recovery of fuel and purchased power costs.

In the past, investors generally bought utility stocks because they wanted relatively low risk and predictable earnings as compared to other equity investments. Recent changes in the industry, however, have undermined investors' confidence in utility stocks' safety and performance predictability. Therefore, investors are beginning to demand higher returns for the capital they invest in utilities. That is particularly true when the utility's regulatory climate is uncertain.

In the views of rating agencies and equity analysts, Arizona Public Service is subject to considerable regulatory risk, which has put and continues to place downward pressure on credit ratings and stock recommendations. This is a very critical case for APS. The Company is perilously close to a further downgrade which would place it in non-investment grade territory. Debt and equity investors see APS' growth as a "two-edged sword." While, in general, it improves earnings, APS' growth demands also drive enormous capital investment requirements. Investors are closely watching the decisions made by the

Commission on the Power Supply Adjustor and Return on Equity to determine whether the Company will be granted sufficient earnings and an opportunity to improve its credit metrics. These are the twin pillars which support APS' ability to obtain capital on favorable terms and, as importantly, its ability to meet its service territory growth and to continue to provide service at reasonable rates.

Based on my experience as a securities analyst and portfolio manager, I conclude the 11.5% return on equity requested by Arizona Public Service would be perceived by rating agencies and investors as a fair and reasonable rate of return in light of the uncertainties facing the utility. As well, the changes proposed by the Company to the Power Supply Adjustor would be viewed by investors and the rating agencies as important steps to improve the timeliness and certainty of fuel and purchased power cost recovery.

DIRECT TESTIMONY OF JULIE M. CANNELL
ON BEHALF OF ARIZONA UTILITY INVESTORS ASSOCIATION
(Docket No. E-01345A-05-0816)

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME, EMPLOYER AND BUSINESS ADDRESS.

A. My name is Julie M. Cannell. I am the president of my own advisory firm, J.M. Cannell, Inc. My business address is P.O. Box 199, Purchase, New York 10577.

Q. PLEASE DESCRIBE YOUR PROFESSIONAL AND EDUCATIONAL BACKGROUND.

A. My firm, J.M. Cannell, Inc., provides advisory services to electric utility companies and other firms and organizations with an interest in the industry. Prior to establishing my firm in February 1997, I was employed by the New York-based investment manager, Lord Abbett & Company, from June 1978 to January 31, 1997. During my tenure with Lord Abbett, I was a securities analyst specializing in the electric utility and telecommunications services industries; portfolio manager of America's Utility Fund, an equity utility mutual fund; portfolio manager of numerous institutional equity portfolios; and co-director of Lord Abbett's Equity Research Department. Further information on my background is set forth in Exhibit JMC-1.

Q. HAVE YOU SUBMITTED TESTIMONY PREVIOUSLY BEFORE ANY STATE REGULATORY AGENCIES?

A. Yes, I have. I have submitted pre-filed testimony on behalf of investor-owned utilities before Public Service or Public Utility Commissions in the states of

Kansas, Missouri, Oklahoma, Pennsylvania, South Carolina, Texas and Washington.

Q. WHAT IS THE SCOPE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. I have been asked to discuss the perspective of investors with respect to the overall financial condition, including the return on equity, credit metrics and cash flow for Arizona Public Service Company ("APS" or "Company") in the context of the current rate case.

Q. PLEASE SUMMARIZE WHAT IN YOUR EXPERIENCE ALLOWS YOU TO PROVIDE TESTIMONY ABOUT THE VIEWPOINT OF INVESTORS.

A. As a securities analyst for approximately 20 years, I specialized in the electric utility industry and the individual companies comprising it. As a portfolio manager, I applied that knowledge, along with investment fundamentals, toward investment decisions on behalf of institutions and individual investors. Moreover, I have reviewed various analyst and rating agency reports, which have addressed the Company and its regulatory situation.

Q. AS AN ANALYST OR PORTFOLIO MANAGER, DID YOU FOLLOW APS OR ITS PARENT COMPANY, PINNACLE WEST CAPITAL CORPORATION ("PINNACLE WEST")?

A. Yes, I did. I monitored the Company and Pinnacle West for both Lord Abbett's equity portfolios and America's Utility Fund.

Q. PLEASE DESCRIBE HOW YOUR TESTIMONY IS ORGANIZED.

A. There are four parts to my testimony.

How Investors Evaluate Investments in Utility Companies—This section discusses why investors choose to invest in electric utilities, with particular emphasis on why the regulatory climate in which the utility operates is of such importance to investors. This section of the testimony also discusses why the risk of investing in the electric utility industry has risen substantially in recent years on an industry-wide basis and why markets today react so swiftly and strongly to unfavorable news about a company.

Investors' Perceptions Related to the Present Proceeding—This section reviews the investment community's perceptions of APS and Arizona regulation. This review is based on a number of recent publications by rating agencies and investment analysts discussing their perceptions of the rate case and the Company's regulatory environment.

Power Supply Adjustor—This section discusses the emphasis which both rating agencies and analysts place on timely and assured recovery of fuel and purchased power costs. My conclusion is that improvements to APS' recovery mechanism are a key component in stabilizing and starting to improve investors' perceptions of the Company.

Return on Equity—This section discusses APS' request for an 11.5% return on equity. My conclusion is that the Company's proposal is one that investors view as important and constructive—i.e., supportive of credit quality and providing a fair return to equity investors. An allowed ROE of 11.5% would lead to a more predictable stream of earnings and cash flow and would be viewed favorably by rating agencies and the investment community at a time when favorable perceptions and increased financial stability are very critical to the Company.

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. This is a very important case for APS. The Company is perilously close to a further downgrade which would place it in non-investment-grade territory with at least one of the credit rating agencies. Debt and equity investors see APS' growth as a "two-edged sword." While, in general, it improves earnings, APS' growth demands also drive enormous capital investment requirements. Investors are closely watching the decisions made by the Commission on subjects like the Power Supply Adjustor and Return on Equity to determine whether the Company will be granted sufficient earnings and an opportunity to improve its credit metrics. These are the twin pillars which support APS' ability to obtain capital on favorable terms and, as importantly, its ability to meet its service territory growth and to continue to provide service at reasonable rates.

II. <u>HOW INVESTORS EVALUTE INVESTMENTS IN UTILITY COMPANIES</u>

Q. WHY IS IT IMPORTANT TO CONSIDER THE OPINIONS OF THE INVESTMENT COMMUNITY?

A. Investors provide the capital necessary to maintain and expand the Company's infrastructure which, in turn, enables APS to provide reliable service to customers. The terms on which the Company is able to obtain that capital have a direct and measurable impact on retail electric customers and the rates they pay for service. For example, if credit rating agencies such as Moody's Investors

("Moody's") or Standard & Poor's ("S&P") believe that the utility's revenues will be diminished by adverse business or regulatory decisions, those rating agencies will lower their credit ratings for the utility, which raises the cost of debt. Because the cost of debt is a component of the weighted average cost of capital, the increased costs of capital are passed on to electric customers in the form of higher rates.

These concerns and potential increased costs are not hypothetical, as the Commission knows, for APS. Late last year and early this year, rating agencies lowered APS' credit ratings, with S&P moving its rating on the Company's senior unsecured debt to only one step above so-called junk status. This comes at a time when the Company's capital requirements continue to grow to meet Arizona's need for electric power infrastructure. In a letter recently filed in this docket, APS estimates borrowing needs for the years 2007-2010 at $2.5 billion.[1]

The same is true for equity investors. If individual or institutional investors believe that the return they are offered is too low in light of the risk involved, they will either sell their stock or elect not to purchase it, which can drive the stock price down. When a utility has to go to the equity markets to obtain capital, a low stock price requires it to issue more shares of stock to obtain the same amount of money that it would have received for fewer shares if the per-share price had been higher.

The corollary is that when investors believe they are investing in or lending money to a company that enjoys fair, consistent regulation and a reasonable rate

[1] Davis letter to Commissioners, page 7, dated August 1, 2006.

of return, those investors "charge" less for their capital. When debt and equity investors charge less for their capital, utility rates remain lower. Thus, a utility and its electric customers have a shared interest in meeting the expectations of investors and credit rating agencies.

Q. ARE YOU SUGGESTING THAT THE ARIZONA CORPORATION COMMISSION SHOULD CATER TO THE DESIRES OF INVESTORS, WHOSE ORIENTATION IS TO SEEK THE HIGHEST POSSIBLE RETURNS?

A. No. I realize that the Arizona Corporation Commission ("ACC" or "Commission") has to balance the interests of both investors, who want high returns, and electric customers, who want low rates. The point is that there is an optimum cost of equity for the electric customer. If the rate is set too low, it appears that the overall cost of capital is less. In actuality, however, that serves to limit access to the capital markets by driving the cost of capital higher than it would have been had the cost of equity been set at a reasonable level in the beginning. This is particularly true for APS given its service territory's growth demands and corresponding capital needs. Thus, the Commission's decision on rate of return is not simply a zero-sum game, as electric customer groups sometimes suggest. If the rate of return is within a zone of reasonableness, both the utility and electric customers win. If the rate of return is set too low or regulatory cost recovery risk is too high, both the utility and electric customers lose because of the effect on the capital markets.

Q. WHAT GOALS LEAD INVESTORS TO INVEST IN ELECTRIC UTILITIES?

A. Historically, electric utilities have been regarded as investment vehicles that provide stable performance through the ups and downs of market cycles and changing economic conditions. Electric utilities have typically earned a reasonable return even when conditions were not favorable for other companies. Accordingly, electric utility stocks have been particularly valuable holdings when conditions were not favorable to investments in more volatile industry sectors. In other words, investors might see greater returns from investment in other industries when times were good, but they would lose less on electric utility stocks when times were not good.

In addition, the reliability of electric utilities' earnings streams permitted most of the companies to continue to pay regular dividends during both good and bad economic cycles. For investors with a need for regular cash income, the prospect of regular dividends has been an important consideration in making a decision to invest in electric utility stocks.

Based on these factors, investors have traditionally viewed electric utility stocks as bond substitutes. In other words, electric utility stocks have provided regular cash returns in the form of dividends and the shares themselves were seen to have a stable underlying value. As a result, electric utility stocks as a group have tended to move closely in line with the direction of interest rates, but in an inverse relationship. That is, utility stock prices rose when interest rates fell and dropped when rates rose. These factors made electric utilities a preferred investment during economic slowdowns or recessions. Owning them was also a way of balancing the risks in a stock portfolio that included stocks in more volatile industries.

Q. HAVE THE RECENT CHANGES IN THE INDUSTRY INCREASED THE RISK OF INVESTING IN ELECTRIC UTILITIES?

A. Yes. Investors now understand that the predictability of the electric utility industry's earnings, across the sector, has been undermined by, among other things, the restructuring that has taken place in many parts of the country. These risks are in addition to the risks posed by technological, economic, environmental and other policy changes that affect the industry. These increased risks mean that investors no longer perceive electric utilities as a group as being the "safe havens" they once were.

Investors' goals, however, have not fundamentally changed. They still look to electric utilities primarily as defensive investments. They still look for stable performance and regular dividends as the reason to invest in electric utilities. But investors also understand that (1) the investment risk in electric stocks generally has risen significantly and (2) additional risk will frustrate investors' goals for committing capital to this sector.

In the end, investors have a very large universe of stocks from which to select; with the exception of specialty utility funds or some portfolios with specific charter requirements, they have no requirement to own electric utility stocks. Consequently, investors now require a higher return for investing in the electric utility industry to balance the increased risk associated with it.

Q. HOW DO THESE CONCERNS AFFECT APS?

A. In two ways. First, markets make judgments about investment risks that apply to industry sectors as a whole and utilities are now regarded generally as more risky than they were historically. Then, company-specific risk factors are added to sector risk.

Q. IN YOUR EXPERIENCE AS AN ANALYST AND PORTFOLIO MANAGER, COULD A PERCEIVED CHANGE IN A COMPANY'S REGULATORY CLIMATE AFFECT YOUR INVESTMENT OPINION?

A. Absolutely. During my tenure as an active investor, a utility's regulatory environment was a critical factor in my assessment of its investment attractiveness. An adverse regulatory decision could be a key determinant in my recommendation or decision to sell a stock already owned or not make an investment in one under consideration.

Q. WHY IS THE PERCEPTION OF REGULATORY CLIMATE OF SUCH IMPORTANCE TO INVESTORS?

A. Equity investors today are still seeking companies that can offer stability in earnings and dividends. Fixed income investors look for stable and adequate cash flows to ensure payment of principal and interest when due, as indicated by stable credit ratings. The ability to pay dividends and sustain credit ratings is directly related to the consistency and sufficiency of a utility's earnings, which depend in large part on how the utility is regulated. If there is uncertainty about whether regulation will allow a utility the opportunity to earn a reasonable return or will allow the utility to recover its reasonable and prudent costs, then that uncertainty will lead investors to avoid holding investment positions in the utility, all other things being equal.

As a result, investors selecting electric utility stocks today place a very high value on consistent and constructive regulation. Also, with a new round of base rate case filings underway in the industry, the quality of regulation is receiving renewed investor attention. That heightens the need for balanced and constructive rulings in this case.

Q. WHO ARE TYPICAL INVESTORS IN UTILITY STOCKS?

A. There are two kinds of investors: individuals, who generally seek stability and income from their utility holdings, and institutions, which generally seek total return (i.e., price appreciation plus dividend income) from their utility investments.

Q. HOW HAS THE INVESTMENT INDUSTRY ITSELF CHANGED IN RECENT YEARS?

A. In recent years, institutional investors and hedge funds have grown dramatically in the amount of capital they control. This growth has had a significant impact on the speed with which the market reacts to unfavorable developments. The market is much more reactive and much less forgiving than it was in the past when stock ownership was less concentrated. In the context of a regulatory decision, investors won't necessarily wait, as they would have in the past, to see how the ramifications of a decision might play out. Rather, they simply sell their shares if a regulator's decision runs counter to their expectations.

Q. WHY ARE INSTITUTIONAL INVESTORS OF SUCH IMPORTANCE GENERALLY?

A. Because of the sheer size of their investment positions, institutions can effectively direct the course of individual securities and sometimes can move the market as a whole. Institutional investors include financial institutions such as mutual funds, investment companies, insurance companies, commercial and investment banks and various types of public retirement funds. They approach the investment selection process from the standpoint of a portfolio. An investment portfolio is a collection of stocks selected to achieve the highest possible return within a commensurate level of risk. Therefore, institutional investors keep electric utilities in their portfolios only when such stocks contribute to achieving the desired risk/return relationship.

Generally, the customers of institutional investors are individuals and it is they who ultimately gain or suffer loss from changes in the value of the institution's investments. Anyone who has a stake in a retirement plan or owns a mutual fund is directly or indirectly a client of an institutional investor. But, the individuals who make the decisions concerning these investments are paid money managers—how they see their responsibilities to the clients they serve and the way that their performance is judged has a great deal to do with how they react to developments in the market.

Q. WHY ARE INSTITUTIONAL INVESTORS IMPORTANT TO APS AND PINNACLE WEST?

A. Institutional investors today hold approximately 75%-80% of Pinnacle West Capital's total common shares. Such investors can dramatically change the market for Pinnacle West shares. Because institutional investors own large blocks of shares relative to the volumes typically traded, their activity in moving in or out of the Company's shares is often noticeable as a significant change in the price and volume of shares being traded for Pinnacle West. This change may be picked up by other institutional investors, by the investment community in general and eventually by individual investors, leading to a "cascade" effect. Other entities will then look to see what is driving this trend in the stock. If they see support for the trend, they follow the lead of the firms that initially began to move the market and by following the leaders, the late movers further strengthen the trend.

Q. WHY MIGHT AN INSTITUTIONAL INVESTOR CHOOSE NOT TO HOLD INVESTMENTS IN A PARTICULAR ELECTRIC UTILITY?

A. Several factors are drivers. First, institutional investors have fiduciary responsibilities. For example, managers of pension assets fall under Federal ERISA laws, which mandate that a portfolio manager's decisions meet the so-called "prudent man" standard. He or she is expected not to make investment decisions that are unduly risky or to retain stocks that are unduly risky given the investment goals of the portfolio and the function of the stock within it.

In addition, institutional investors have performance pressures. It is not enough for stocks in a portfolio simply to increase in value. Rather, relative performance is what counts. Investment performance is gauged against a market proxy (such as the Standard & Poor's 500 Index) or a peer group of investors (i.e., investors with a similar style, such as value, growth, growth & income, small cap, etc.).

Mutual fund rating organizations such as Morningstar track and publicize the relative performance for mutual funds and various pension consultants perform the same service for their client organizations.

Q. WHAT HAPPENS WHEN AN INSTITUTIONAL INVESTOR UNDERPERFORMS?

A. The results vary, but eventually, underperformance will result in lost business and personnel changes. Mutual fund shareholders can sell their fund shares. A pension plan sponsor can fire the professional investor or reduce the assets under their investor's management. And, of course, poor performance also disadvantages the individual, who has entrusted his monies to the institution for management.

Q. HOW LONG A PERIOD DOES AN INSTITUTIONAL INVESTOR HAVE BEFORE PERFORMANCE BECOMES AN ISSUE?

A. Again, it can vary. But there is little doubt that institutional investors no longer have the luxury of a long-time horizon in which to show performance. Investors want results. And with the public visibility that investment results now have (through organizations such as Morningstar and the various pension consultants) and the resulting performance pressure, most investment organizations are now operating with a much shorter time horizon than in years past. Generally speaking, a long investment time horizon today can be as short as 12-18 months. So, a stock that is unlikely to perform within the prescribed time horizon is usually not attractive for purchase or continued investment by an institutional investor.

Q. WHAT DOES THIS MEAN FOR INVESTMENTS IN PINNACLE WEST AND APS SPECIFICALLY?

A. This shortened timeframe means that if there is bad news, institutional investors will react more quickly. In the instance of a rate proceeding, these investors are unlikely to wait to see what the outcome of the next rate decision will be. That would represent an opportunity cost to them. Rather, institutional investors are now more prone just to sell their shares on the news of an adverse regulatory outcome. This is not good for retail electric customers for the reasons discussed earlier.

Q. DO ALL INSTITUTIONAL INVESTORS FUNCTION WITHIN THE TIME FRAMES YOU DESCRIBE?

A. No. There is a type of institutional investor called a hedge fund that frequently buys and sells the same stock during the course of a day.

Q. WHAT IMPACT DO HEDGE FUNDS HAVE ON THE MARKET IN GENERAL AND STOCKS IN PARTICULAR?

A. Their impact can be dramatic. Hedge funds are well known for trading in information; their actions are frequently event-driven. Sometimes that information is factual and other times it falls into the category of rumor. Because investors at hedge funds have wide information networks and are in frequent communication with a broad range of other investors, they have the ability and the power to create volatility which, in turn, impacts the movement of stock prices. The number of hedge funds participating in the market and the funds' assets have grown exponentially in recent years—recent estimates put the numbers at over 8,500 firms with assets of $1.26 trillion globally in 2005, with the top 134 U.S.

hedge funds' assets at almost $631 billion. That compares to only 610 firms with $39 billion in assets in 1990. Thus, they have become a very strong force both in the market and in stocks in which they are interested. When they like an industry group or a stock, hedge funds can provide substantial support to stock prices. But, conversely, when they become disenchanted, their tendency is to sell quickly and without remorse. Although their focus is not on contributing to orderly markets, hedge funds are a formidable presence in the marketplace and must be reckoned with.

Q. CAN YOU GIVE AN EXAMPLE OF HOW HEDGE FUNDS MIGHT TRAFFIC IN PINNACLE WEST'S STOCK?

A. Investors have been aware of the current proceeding for months. Hedge funds assuredly have made assumptions about the case, including its resolution. If, when the Commission's decision is announced, the details fall short of those expectations, the hedge funds could put significant pressure on the stock, either through outright sales or short-selling (i.e., selling stock that is borrowed in anticipation that the price of the stock will drop before the borrowed stock must be replaced). Hedge funds seek to get ahead of the broader market and react to news before the market can. Accordingly, if hedge funds decide to make moves on Pinnacle West's shares based on the order in this proceeding, they will begin to do so within hours of the release of the order.

Q. WHAT ROLE DO CREDIT AGENCIES PLAY IN INVESTORS' EXPECTATIONS?

A. In the wake of financial disasters, bankruptcies and the ensuing severe erosion in investor confidence in the past few years, credit issues have become critically important not only to fixed income investors, but also to equity investors. While credit downgrades initially impacted only the most troubled companies, a spillover effect soon was seen on healthy utilities. Part of this was due to the fact that the rating agencies came under harsh criticism that they had failed to catch problems early enough in companies such as Enron Corp. As a result, they began to heighten their scrutiny of all entities under their watch and became far more proactive in making rating changes. As well, "headline risk" began to come into play as investors worried that—when credit problems in an industry are in the headlines—any company in the sector could be vulnerable to a downgrade. Thus, equity investors now closely watch the actions of the credit agencies, because any change in ratings can have a significant impact on a company's stock price.

Q. WHAT HAPPENS WHEN A CREDIT DOWNGRADE OCCURS?

A. In the simplest terms, it becomes more expensive for a company to raise money in the capital markets because a downgrade raises a company's risk profile and, consequently, increases the cost of debt. And because of the increased linkage these days between ratings and stock prices, the price frequently reacts—sometimes quite strongly—to a downgrade. For example, Moody's cut the ratings of Allegheny Energy and its subsidiaries to "junk," or below investment-grade, status on October 1, 2002. The prior day, September 30, Allegheny's stock price closed at $13.10. By October 8, when the company announced that it was in technical default with creditors due to its inability to meet higher collateral requirements prompted by the downgrade, the stock closed at $3.80. Thus, in the space of a week, Allegheny's stock price—and the value of a shareholder's investment—lost 71% of its value. This example is indicative of how the markets now watch changes in credit ratings so closely. For APS, it indicates how the ratings downgrades and any further negative ratings action can collapse stock prices as well.

III. <u>INVESTORS' PERCEPTIONS OF THE CURRENT PROCEEDING</u>

Q. HOW HAVE YOU GAUGED INVESTORS' PERCEPTIONS OF THE ISSUES IN THIS PROCEEDING?

A. To supplement my own knowledge of the industry, I have reviewed various reports related to APS and Pinnacle West written by the credit rating agencies and investment analysts. A clear picture of investors' perceptions emerges from these reports, which is very much in keeping with my own views.

Q. WHICH CREDIT AGENCY REPORTS HAVE YOU REVIEWED?

A. I have examined reports written by Moody's, S&P, and Fitch Ratings ("Fitch"), which are the three key credit rating agencies.

Q. WHY IS A UTILITY'S REGULATORY ENVIRONMENT IMPORTANT TO THE RATING AGENCIES?

A. The rating agencies appraise companies on the basis of creditworthiness. They evaluate current financial soundness and attempt to discern how that might change in the future. One of the key factors in assessing a utility's financial picture is the regulatory climate in which the company operates because, among other things, regulators establish the returns that may be earned on the capital structure and make many other decisions impacting a company's financial health. Thus, a regulatory environment characterized by consistency and predictability is one that lends itself to a company's having a sounder financial base. Conversely, a regulatory situation defined by a lack of stability has a deleterious impact on a utility's credit profile.

Q. HOW DO THE RATING AGENCIES VIEW APS AND ITS REGULATORY SITUATION?

A. While their opinions vary somewhat, all three agencies place significant emphasis on the actions of the Commission and the impact that those actions have on the Company's financial health. The agencies generally share the opinion that APS' regulatory environment is characterized by risk and uncertainty.

Q. PLEASE ELABORATE.

A. As noted in the pre-filed direct testimony of Pinnacle West and APS Chief Financial Officer Donald E. Brandt, Moody's placed the long-term ratings of APS under review for possible downgrade on January 10, 2006. As Mr. Brandt noted, "The agency declared that an uncertain regulatory environment in combination with the absence of timely recovery of increased fuel and purchased power costs precipitated this action."[2] In a report on the Company issued the following day, Moody's cited "Growth rates within the company's service territory are above the national average" as a "Credit Strength." "Credit Challenges" included "Growing territory requires increasing amounts of capital expenditures" and "Significant rate increases are required to recover costs associated with capital investments as well as increased expenses for fuel, purchased power."[3]

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[2] Pre-Filed Direct Testimony of Donald E. Brandt On Behalf of Arizona Public Service Company, Docket No. E-01345A-05-0816, January 31, 2006.
[3] Moody's Investors Service, "Credit Opinion: Arizona Public Service Company," January 11, 2006.

The agency's review of the Company and its parent resulted in a ratings downgrade on April 27, 2006. Moody's stated that its action stemmed from the recommendation of the Commission's Administrative Law Judge in APS' petition for emergency interim rate relief that was roughly half the amount sought: "The rating downgrades reflect deterioration in key financial metrics as a result of increased fuel and purchased power costs that APS is unable to recover on a timely basis."[4]

Q. DID MOODY'S OPINION ON APS CHANGE AS A RESULT OF THE ACC'S MAY 2 RULING ON APS' EMERGENCY INTERIM RATE PETITION?

A. No. The rating agency issued another credit opinion on the Company on May 9 in which it maintained the Negative Outlook and existing rating structure. While noting the May 2 Commission decision without evaluative comment, Moody's reiterated its position on the possibility of additional downgrade action in the absence of supportive and timely rate decisions in this case. As to the chance of a ratings upgrade, the agency did say that prospective supportive regulatory treatment could result in strengthened key financial ratios, which initially would likely result only in stabilizing the rating outlook.[5]

Q. WHAT IS S&P'S VIEW OF APS IN THE CONTEXT OF ARIZONA REGULATION?

A. Standard and Poor's ("S&P") also downgraded the ratings of APS and its parent in December 2005. S&P's action reduced the credit ratings to the last notch of

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[4] Moody's Investors Service, "Rating Action: Moody's Downgrades Pinnacle West (Issuer Rating to Baa3) and Arizona Public Service (Sr. Uns. to Baa2); Ratings of Pinnacle West Remain Under Review," April 26, 2006.

[5] Moody's Investors Service, "Credit Opinion: Arizona Public Service Company," May 9, 2006.

investment grade. S&P stated that: "This action is based on increased regulatory and operating risk at APS. Specifically, Standard & Poor's is concerned that the Arizona Corporation Commission (ACC) is not expeditiously addressing APS' growing fuel and purchased-power cost deferrals, which have grown much more rapidly than expected in 2005, particularly because of elevated gas prices and the utility's increased dependence on this fuel."[6]

S&P opined several weeks later on the fuel and purchased power recovery mechanism established in the Company's last major rate case: "Regulatory uncertainty is exacerbated by the establishment in 2004 of a weak power supply adjuster [sic] (PSA) that exposes the utility to potential cash volatility. APS has been forced to defer $170 million of fuel and purchased power costs at the end of 2005, an amount that may grow to as large as $250 million by the end of 2006."[7] Subsequently, S&P commented on the ACC's May 2 Decision by maintaining APS' ratings level and Stable Outlook. The agency noted that the Commission's approval of "additional rate adders for retail customers is a step in the right direction as it stems the growth of deferred balance levels. Yet deferrals are not expected to be eliminated and will continue to be an ongoing concern for consolidated credit quality in 2006 and 2007."[8] S&P also said that "continued regulatory support will be required to determine how deferred balances will ultimately be reduced."[9] The agency concluded that both APS' and Pinnacle West's stable outlook is "premised on the ACC continuing to provide sustained

[6] Standard & Poor's, "Research Update: Pinnacle West Capital's, Arizona Public Service's Ratings Lowered to 'BBB-'; Outlook Stable," December 21, 2005.
[7] Standard & Poor's, "Summary: Arizona Public Service Co.," February 15, 2006.
[8] Standard & Poor's, "Summary: Arizona Public Service Co.," May 10, 2006.
[9] Ibid.

regulatory support that addresses permanent rate relief and manages the deferral balances downward over a reasonable time frame."

Q. WHAT DO YOU CONCLUDE FROM S&P'S COMMENTS?

A. S&P was encouraged by the Commission's decision in early May. But, it has significant concerns about the Company's Power Supply Adjustor ("PSA") and is closely watching this case for constructive regulatory treatment in order to maintain APS' and Pinnacle West's ratings at existing levels.

Q. HOW DOES FITCH VIEW APS?

A. Like the other credit rating agencies, Fitch also downgraded APS and Pinnacle West. On January 30, 2006, the agency lowered the parent's ratings to BBB- and APS to BBB reflecting, in part, the Commission's January 25 decision in the utility's PSA proceeding and APS' "significant exposure to high and rising natural gas commodity costs."[10] Fitch applauded the removal of the PSA cost cap and deferred cost recovery acceleration, but noted that the "ACC bench order rejecting APS' $80 million surcharge request on procedural grounds and restriction of PSA adjustments to an annual reset is less favorable than Fitch had anticipated in its previous ratings and is a significant source of concern for PNW [Pinnacle West] and APS fixed-income investors."[11]

More recently, Fitch on May 5 addressed the Commission's ruling in APS' emergency rate case. It cited the Commission's "supportive response to the company's request," but noted that "prior rate decisions have been less

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[10] Fitch Ratings, "Fitch Lowers PNW & APS' Sr. Unsecured Ratings to 'BBB-' and 'BBB', Respectively; Outlook Stable," January 30, 2006.
[11] Ibid.

constructive to the credit profile of APS" and referenced Fitch's January downgrade actions.[12]

Q. WHAT CONCLUSIONS DO YOU DRAW FROM THE RATING AGENCIES' REPORTS?

A. All three credit agencies share a concern that the Arizona regulatory backdrop is challenging and uncertain for APS. They have acted on that concern by downgrading the credit ratings of the utility and its parent, with S&P moving the ratings to only one notch away from below investment grade and Moody's and Fitch to only two notches away. Specifically, the agencies are unanimously concerned about the mounting level of the Company's deferred fuel and purchased power costs due to lack of timely as well as anemic regulatory decisions, the limitations of the Company's PSA and the negative toll that the growing deferrals are having on APS' credit metrics. Indeed, Moody's noted the need for APS to have stronger financial metrics than comparably rated utilities due to the challenging regulatory environment. S&P, while encouraged by May's Commission action, needs to see continued constructive regulatory treatment to maintain the Company's rating at existing levels. Fitch also applauded the Commission's more supportive posture recently toward APS, but implied some doubt about a continuation of that trend by pointing out that prior decisions have been less constructive.

[12] Fitch Ratings, "Fitch Comments on PNW Subsidiary APS's Emergency PSA Rate Order," May 5, 2006.

Q. PLEASE TURN YOUR ATTENTION NOW TO THE REPORTS OF SECURITY ANALYSTS REGARDING APS. WHAT ARE THEIR OPINIONS ABOUT THE COMPANY'S REGULATORY CIRCUMSTANCES?

A. A number of investors have commented on APS' regulatory situation and its impact on the Company's investment attractiveness. They appreciate the fact that the utility faces significant capital expenditures to support customer demand in its fast-growing service territory. The analysts also share the opinions of the credit rating agencies that the Arizona regulatory environment is challenging and uncertain.

Q. WHAT ARE SOME OF THE ANALYSTS' OBSERVATIONS?

A. Security analysts are largely cautious on Pinnacle West's stock because of the presence of regulatory risk. For example, Morgan Stanley downgraded its investment opinion to "Underweight" last September due to "more expected regulatory uncertainty" in the context of Arizona's traditionally "difficult regulatory environment."[13] Other brokerage firms, which rate the stock "Neutral," "Equal weight," or "Hold," consistently cite APS' regulatory uncertainty in supporting their investment opinion. As was true of the credit rating agencies, the security analysts' concerns center on the mounting level of cost deferrals relating to fuel and purchased power expense, which is compounded by the Commission's failure to render decisions in a timely fashion.

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[13] Morgan Stanley, "Pinnacle West: Downgrading on More Expected Regulatory Uncertainty," September 19, 2005.

Q. PLEASE ELABORATE ON SOME OF THE INVESTORS' OPINIONS.

A. Lehman Brothers has repeatedly characterized the Arizona regulatory environment as being challenging. In its discussion of second quarter results, the investment firm recently noted: "We continue to see Arizona as a challenging regulatory environment, and the GRC [General Rate Case] before the ACC as providing regulatory risk overhang to the stock in the near to medium term."[14] Lehman, in commenting on the ACC's May 2 decision in APS' emergency request, said: "Even with this recovery, in APS' own estimation there is a 35% chance of a credit downgrade to junk status by one or more of the rating agencies. It seems the ACC is willing to let APS skirt the line of junk status while not permanently addressing fuel recovery, and using fuel recovery proceedings as leverage over the company to securitize and debate APS' other costs."[15]

Q. WHAT HAVE OTHER INSTITUTIONAL INVESTORS HAD TO SAY ABOUT APS' REGULATORY SITUATION?

A. J.P. Morgan stated:

> "Our focus going forward will be on the regulatory front, which is expected to be challenging. Although on the surface the rate case appears fairly straight forward, we continue to believe it will be a challenge for the company. Not only has Arizona been a difficult regulatory environment historically, the magnitude of the increase combined with the April rate increase and rising commodity prices may be too large politically. We are maintaining our Neutral rating."[16]

Harris Nesbitt also weighed in on Arizona regulation:

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[14] Lehman Brothers, "Pinnacle West Capital: PNW Beats Street on Growth & Weather," July 21, 2006.
[15] Lehman Brothers, "Pinnacle West Capital: Skirting the Line in Arizona," May 3, 2006.
[16] J.P. Morgan, "Pinnacle West Capital Corp.: Raising 2005E EPS; Regulatory Overhang Remains," October 27, 2005.

"**Recommendation**: We reiterate our **NEUTRAL** rating, recognizing Arizona remains a challenging regulatory jurisdiction and PNW is in the midst of a significant rate proceeding.

Details & Analysis: While strong customer growth remains a driving force, the pressure to serve that growing demand is expected to keep PNW before the regulators for the foreseeable future. As such, we regard regulatory uncertainty as a constant for Pinnacle West, particularly since regulation in Arizona has been less constructive relative to many other states, in our opinion, although we regard recent commission decisions (discussed below) as reasonable."[17]

Q. WHAT OPINIONS DID CITIGROUP OFFER?

A. The brokerage firm clearly conveyed that APS' ongoing exposure to regulatory risk is the dominant investment factor impacting the Company and its parent. In a January 10, 2006 report, Citigroup stated, "Our '07 target multiple is a discount to the average defensive utility multiple to account for regulatory uncertainty. Overall, we believe this target multiple reflects Pinnacle's high proportion of regulated earnings and dividend growth, offset by a weak balance sheet and potential future regulatory risk."[18] The firm more specifically and forcefully addressed APS' regulatory environment several weeks later:

"We believe that for the near-term under-recoveries are manageable through adjustor/surcharge recoveries, cash on hand and the pending equity infusion of over $200mm of Silverhawk asset sale proceeds, which closed 1/10/06. ***However, if the ACC continues to assume equity holders will finance in perpetuity the legitimate costs incurred to deliver service to Arizona ratepayers the situation could lead to a further credit downgrade (APS is already BBB-), cause bond spreads to widen, trigger collateral calls, and materially impair the company's ability to access the equity capital markets at favorable terms***."[19] [Emphasis added]

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[17] Harris Nesbitt, "Pinnacle West Capital, Regulatory Uncertainty Continues to Pressure the Earnings Outlook," May 11, 2006.
[18] Citigroup, January 10, 2006, op. cit.
[19] Citigroup, February 2, 2006, op. cit.

Q. WHAT IS THE IMPORT OF THESE ANALYSTS' COMMENTS?

A. Investors are very clear in conveying that ACC actions matter significantly. They are acutely aware that APS is in the midst of a general rate case, the Company continues to be in an under-recovered position for its fuel and purchased power expenses and the utility's need for rate relief will be ongoing. They acknowledge that regulatory risk has brought and is likely to continue to keep Pinnacle West's stock under pressure and is a primary reason why the analysts remain cautious in their investment posture toward the Company. Given this, it is not surprising that some investors are conservative in their assumptions about the ROE award.

Q. HAVE INVESTORS ALSO CONVEYED THEIR EXPECTATIONS FOR A RETURN ON EQUITY AWARD IN THE CURRENT PROCEEDING?

A. Merrill Lynch's expectation is for an 11.5% ROE award: "The outlooks remains heavily dependent on the pending rate case, for which we assume jurisdictional rate base of \$4.4B, 50% equity and an 11.5% ROE."[20] Citigroup is assuming a 10.5% ROE, with a downside of 10.25%.[21] Lehman Brothers' model incorporates a 10.25% ROE:

> "The new rate base of \$4.4 Billion is likely to be accepted along with the Equity ratio of 54.3%, as there has yet to be a case, to our knowledge, in Arizona where actual equity capitalization has be[sic] denied. Pro-forma equity in some cases has been used. The ROE is likely to be the item that is most at risk for reduction. The table below shows the EPS sensitivity to shifts in the ROE and Equity Ratio:

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[20] Merrill Lynch, May 10, 2006, op. cit.

[21] Citigroup, "Pinnacle West Capital Corporation, PNW: Palo Verde 1 Appears Fixed. Rate Case Next Issue," July 13, 2006.

SHIFT	EPS SENSITIVITY
-100bp in ROE	($0.24)
-1% in equity ratio	($0.05)

> We are maintaining our 2007 EPS guidance of $3.40. We are using a 10.25% ROE, equivalent to the outcome of the prior rate case, at actual equity levels, in our 2007E EPS.[22]

Q. ALTHOUGH MERRILL LYNCH'S FORECAST ASSUMES AN ROE AWARD CONSISTENT WITH THE COMPANY'S REQUEST, BOTH CITIGROUP'S AND LEHMAN BROTHERS' EXPECTATIONS ARE BELOW THE 11.5% LEVEL. HOW DO YOU EXPLAIN THAT DISPARITY?

A. It is not surprising that some investors are conservative in their assumptions about the ROE award. The estimated ROE allowances of Citigroup and Lehman represent the floor of a range of expected allowances from 10.25%-12% that investors would consider to be reasonable. Lehman expressly states that its estimate is equivalent to the outcome of APS' last general rate case. Further, the analysts' assumptions reflect uncertainty about the supportiveness of Arizona regulation, particularly in the current climate of rising energy prices and interest rates. Thus, they are likely erring on the side of conservatism in anticipating this case's outcome. Indeed, this regulatory uncertainty is also reflected in Lehman's recent ranking of state utility commissions from an investor perspective. That is part of the reason that Lehman's 10.25% ROE is at the bottom of the expected range of outcomes. Arizona's ranking of "Tier 5" has remained consistent in Lehman's annual regulatory studies since the publication commenced in 2004.[23]

[22] Lehman Brothers, July 21, 2006, op. cit.
[23] Lehman Brothers, "They're Back! Twenty-Six Rate Cases This Year Give Rise to the Regulators," March 5, 2004; and "Hurry Up and Wait: 41 Rate Cases in Next Two Years as Companies Strive to Avoid Regulatory Lag," April 19, 2005.

Q. DID LEHMAN COMMENT FURTHER ON ROE AWARDS IN GENERAL?

A. Yes. The firm presented projections for annual allowed returns on equity for the industry for 2006 through 2010. For this period, Lehman is estimating an 11.3% ROE award for each of those years. The firm notes, however, that "Primarily because of regulatory lag and increased financing expenses, utilities suffer subpar returns during periods of heavy capital investment." Further, "...as the sector becomes FCF [free cash flow] neutral (by late 2005), utilities tend to earn 225 bps [basis points] below their allowed ROEs. . . . As FCF trends downward through 2007, this implies more substantial under-earning over the next few years." Lehman's projections of projected <u>earned</u> ROEs are: 2006, 9.02%; 2007, 8.71%; 2008, 9.13%; 2009, 9.57%; and 2010, 9.83%.[24]

Q. WHAT ARE THE IMPLICATIONS OF LEHMAN'S INDUSTRY ROE ANALYSIS FOR APS' REQUESTED ROE?

A. There are several points to be made. First, the firm is projecting an 11.3% average allowed ROE for the industry over each of the next five years. That projection reinforces the likelihood that both Lehman's and Citigroup's ROE estimates for the Company are conservative and represent the low end of the range and that Merrill's projection of an 11.5% ROE is at the upper end of a band of 10.25%-11.5% expected by investors. Second, Lehman is anticipating an allowed ROE level of 11.3% over each of the next five years, but an <u>earned</u> ROE ranging from 143 basis points on the high end (2010) to 259 basis points on the low end (2007) below the allowed ROE due to cash flow pressures. The

[24] Lehman Brothers, "Capital Lessons," <u>op. cit</u>.

Company's free cash flow is already being pressured by significant spending on transmission and distribution infrastructure as well as by deferred fuel and purchased power expenses. In that context, the lower the return on equity that APS is *allowed*, the lower the *earned* return on equity that will actually be achieved.

IV. <u>POWER SUPPLY ADJUSTOR</u>

Q. YOU'VE STATED THAT BOTH THE CREDIT RATING AGENCIES AND SECURITY ANALYSTS ARE CONCERNED ABOUT APS' RISING LEVEL OF DEFERRED FUEL AND PURCHASED POWER COSTS. PLEASE ELABORATE ON THAT.

A. Recovery of fuel and purchased power costs—essential expenditures in providing electricity to customers and a major component in a utility's cost structure—is a key issue to investors. In a study I conducted for the Edison Electric Institute last year on investor perceptions of various state regulatory issues, over half the analysts believe that recovering these expenses should occur on a regular, ongoing basis without deferrals and that regulatory mechanisms should be in place to handle recovery. The remaining investors don't disagree with that opinion, but expressed worries about fuel recovery due to "sticker shock" and potential subsequent prudence reviews because of high commodity prices and increased political motivation of regulators. As to purchased power cost, the respondents also endorsed recovery, saying it was a "legitimate expense" and a "fixed obligation" that should be recovered on an "ongoing basis, with routine updating of cost."[25] The difficulty that APS continues to experience in obtaining timely

[25] J.M. Cannell, Inc., "State Utility Regulation: An Assessment of Investor Perceptions," August 2005.

recompense for these major elements of its cost structure, and the pressure that brings to bear on the Company's financial well-being, are of paramount concern to investors and a major investment negative.

Q. PLEASE COMMENT ON INVESTORS' VIEWS OF THE COMPANY'S CURRENT MECHANISM FOR FUEL AND PURCHASED POWER RECOVERY.

A. Investors, while applauding the adoption of a mechanism in APS' 2005 rate case permitting some level of fuel and purchased power cost recovery (Arizona previously had been one of only a limited number of states without a recovery vehicle), have also recognized the limitations of the PSA.

Q. DO INVESTORS' CONCERNS ABOUT THE PSA IMPACT THEIR ASSESSMENT OF THE RISKS OF EITHER BUYING PINNACLE WEST STOCK OR LENDING MONEY TO APS FOR ITS CAPITAL NEEDS?

A. Yes. Investors almost universally rate Pinnacle West's investment attractiveness neutrally, with concerns about adequate and timely cost recovery widely stated as a reason for that posture. Credit rating agencies share the same concerns.

Q. IN ITS FILING, APS HAS RECOMMENDED SEVERAL CHANGES TO THE PSA. WOULD THOSE CHANGES ADDRESS THE CONCERNS BEING RAISED BY THE INVESTMENT COMMUNITY?

A. Yes, I believe they would. In particular, elimination of the $776 million fuel cost cap or raising it substantially as APS suggests would remove much of the uncertainty perceived as to whether prudently incurred expenses above that level are recoverable. Changing the cumulative 4-mill cap on the annual PSA adjustment to an annual 4-mill cap would also permit much more timely and routine recovery of fuel and purchased power costs. While I personally am not conversant with the details of the PSA and its specific problems, I do believe that these changes to the PSA would address several investor concerns by providing more certain and timely recovery of fuel and purchased power expenses.

Q. ARE THERE ADDITIONAL INFERENCES TO BE DRAWN FROM INVESTORS' VIEWS OF THE COMPANY?

A. Yes. One of the key factors analysts use to evaluate the quality of a regulatory climate is the consistency of a commission. Investors value certainty and predictability; a lack of consistency in a commission's decisions serves to increase the investment risk associated with the Company. Investors are unable to anticipate reliably the future actions of a commission which has an unpredictable track record of regulatory decisions. That in turn depresses valuations—i.e., lowers the price of a stock—or increases a company's cost of borrowing. In the state regulatory perception study I previously cited, respondents were asked to cite the regulatory factors they felt characterized a constructive environment as well as a non-constructive environment. On the positive side of the ledger, one of the top set of factors, comprising 18% of total responses, was a regulatory climate that is "fair, stable, predictable, and consistent." The top factor cited by the respondents as characterizing a non-constructive environment (45% of replies) was a climate that is "arbitrary, inconsistent, and unwilling to acknowledge the economic realities that utilities face." One investor summed up that type of non-constructive regulation as "regulatory purgatory."[26]

[26] Ibid.

Q. PLEASE SUMMARIZE THE PERSPECTIVE OF SECURITY ANALYSTS AND OTHERS REPRESENTING THE INVESTOR VIEWPOINT ON THE ARIZONA REGULATORY ENVIRONMENT AS IT RELATES TO APS.

A. There is a general perception among investors that the regulatory environment in which the Company operates is characterized by risk and uncertainty. Security analysts are keenly aware that APS is facing not only a general rate case this year, but also ongoing regulatory exposure in recovering deferred fuel and purchased power costs. Accordingly, they have a cautious view on Pinnacle West's stock.

Q. HOW DOES THIS VIEW OF REGULATORY UNCERTAINTY IMPACT THIS CASE?

A. Uniformly, the rating agencies and investment analysts viewed positively the Commission's decisions in late January and early May of this year. It is equally obvious, however, that they are carefully watching this case to see if the Commission will continue to address positively APS' credit metrics, problems with the PSA and the quantity and quality of APS' earnings. Favorable rulings on case issues such as strengthening the PSA will show consistency with these earlier decisions and are particularly critical given APS' shaky credit ratings.

V. RETURN ON EQUITY FOR APS

Q. HOW DO YOU BELIEVE APS' REQUESTED RETURN ON EQUITY OF 11.5% COMPORTS WITH INVESTORS' PERCEPTIONS?

A. The investment community would find an 11.5% ROE supportive for the Company. It is within the range of investors' expectations for ROE allowances in 2006 and particularly appropriate for APS at this time for the reasons I just discussed.

Q. IN THE CURRENT LOW INTEREST RATE ENVIRONMENT, DO YOU CONSIDER INVESTORS' EXPECTATIONS REGARDING THE COMPANY'S PROSPECTIVE ROE AWARD TO BE REASONABLE?

A. Yes, I do. Interest rates, though recently having reached historically low levels, are once again rising. And the interest rate factor is not the only one that investors are taking into account. Because of the greater risks that the industry is facing, investors are now requiring a higher risk premium generally on their utility investments. For APS, they see additional regulatory risk and, of course, are well aware that it stands on the precipice of a non-investment grade rating. An anemic ROE award at the current time would quickly reverse the earnings prospects for the utility and eliminate the progress achieved in this year's decisions. With already limited financial flexibility and an existing weak cash flow situation relative to its investment grade status, APS' need to access the capital markets will become greater as the risk of credit downgrades becomes even more pronounced which, in turn, will result in a vicious negative cycle.

Q. WILL A RETURN ON EQUITY AWARD THAT IS CONSISTENT WITH INVESTOR EXPECTATIONS ALSO PROVIDE BENEFITS TO APS CUSTOMERS?

A. Absolutely. A higher ROE permits the realization of a stronger earnings stream. In turn, that improves Pinnacle West's stock valuation prospects, which results in a higher stock price. Thus, when APS needs to tap the equity markets for capital needed to meet customer needs, it gets more for its money. Said another way, each share sold brings more equity into the Company with the same commitment by the Company to generate earnings and pay dividends to support the value of that share. In regard to debt financing, a higher ROE awarded to APS would be viewed as a sign of constructive regulation and would be positive for the Company's credit rating. Importantly, in both cases, customers' rates will reflect this lower cost of capital.

Q. FINALLY, ARE YOU FAMILIAR WITH THE RECENT PROPOSAL TO CREATE A SO-CALLED RATE STABILIZATION FUND?

A. I have read the exchange of correspondence between Commissioner Mayes and Mr. Davis on that subject.

Q. DO YOU HAVE ANY REACTION TO THIS PROPOSAL FROM AN INVESTOR'S PERSPECTIVE?

A. As I understand it, this proposal would require company shareholders to assume a portion of the costs directly incurred by utility customers in their consumption of electricity. As a general proposition, such a regulatory policy would be viewed very negatively by investors and rating agencies. Specifically, this proposal would further undermine the earnings of a company whose actual ROE is far below what has been authorized by this Commission and about half of the national average for the industry.

Q. DOES THIS COMPLETE YOUR TESTIMONY?

A. Yes.

Exhibit JMC-1

JULIE M. CANNELL
P.O. Box 199
Purchase, New York 10577

BUSINESS EXPERIENCE:

1997-	J.M. CANNELL, INC.	
		President of firm providing advisory services specializing in the electric utility industry.
1977-1997	LORD ABBETT & COMPANY, New York, New York	
1995-1997		Equity Portfolio Manager. Responsibility for management and client servicing of ten institutional equity portfolios with total assets in excess of $700M. Actively and successfully involved in new institutional business marketing effort.
1994-1996		Associate Director of Equity Research. Provided oversight of departmental activities, including supervision of analysts' research efforts and support staff functions.
1992-1995		Portfolio Manager, America's Utility Fund. Full portfolio management responsibility for the fund since its May 1992 inception.
1978-1995		Securities Analyst. Sole responsibility for analysis of and stock recommendations for the electric utility and telecommunications industries. Other areas of coverage previously included housing (2 years) and pollution control (1 year).
Summer 1977		Research Assistant in Utilities.
1973-1976	UNIVERSITY OF COLORADO, Colorado Springs, Colorado	
		Public Services Librarian Instructor in Bibliography to undergraduate and M.B.A. students

1971-1973	CAMERON COLLEGE, Lawton, Oklahoma.
	Reference Librarian

EDUCATION:

1978	COLUMBIA UNIVERSITY, MBA - Finance
1971	EMORY UNIVERSITY, M.Ln. - Librarianship
1970	MARY BALDWIN COLLEGE, B.A. - English

MEMBERSHIPS:

Chartered Financial Analyst (C.F.A.)
CFA Institute
New York Society of Security Analysts
Wall Street Utility Group